

Internal Revenue Service

memorandum

CC:TL-N-7501-88

Brl:CEButterfield

date: AUG 15 1988

to: Special Trial Attorney, Jacksonville

CC:JAX

from: Director, Tax Litigation Division

CC:TL

subject: [REDACTED]

This responds to your request for technical advice dated June 15, 1988.

ISSUES

1. Whether petitioner is entitled to use the LIFO inventory method for raw materials in conjunction with its use of the completed contract method. 0451-1600

2. Whether petitioner may transfer goods from inventory to specific construction projects at average cost, rather than at most recent LIFO cost. 0451-1600

CONCLUSIONS

1. We should not contest petitioner's use of the LIFO inventory method for undedicated raw materials in conjunction with its use of the completed contract method.

2. Petitioner should transfer goods from inventory to specific construction projects at most recent LIFO cost.

FACTS

The taxpayer is engaged in the construction of [REDACTED] facilities and other large steel constructions. It reports its income from both long and short-term contracts on the completed contract method. Starting in the tax year ending [REDACTED] the taxpayer used a LIFO inventory pool to account for undedicated raw materials, in conjunction with the completed contract method. The initial LIFO adjustment resulted in an increased cost of goods sold in the amount of \$[REDACTED]. The adjustment was disallowed on the basis that the use of LIFO was inconsistent with the use of the completed contract method. Taxpayer applied the same method, resulting in smaller but significant adjustments, in tax years [REDACTED]-[REDACTED]. Appeals has recommended concession of the issue in years [REDACTED]-[REDACTED].

08540

LEGAL ANALYSIS

I.R.C. § 451 states the general rule that any item of gross income shall be included in income for the taxable year in which it was received unless the method of accounting used by the taxpayer requires its inclusion in a different period. Such methods are also subject to the general requirement of section 446, that income be clearly reflected. Treas. Reg. § 1.451-3(a) states that one acceptable method of accounting for income from long-term contracts is the completed contract method. Under the completed contract method income from long-term contracts is reported in the year in which the contract is completed, and expenses allocated to the contract are deducted from gross income in the year in which the contract is completed. Treas. Reg. § 1.451-3(d)(1).

Section 471 states that inventories must be used when, in the opinion of the Secretary, they are necessary clearly to determine income. Treas. Reg. § 1.471-1 states that inventories are required whenever the production, purchase or sale of goods is an income producing factor. Treas. Reg. § 1.471-10 refers taxpayers using the completed contract method to the rules at Treas. Reg. § 1.451-3. The LIFO method of computing inventory is permitted under section 472, and the regulations thereunder. Treas. Reg. § 472 1(a) provides that any taxpayer permitted or required to use inventories under section 471, and pursuant to Treas. Reg. §§ 1.471-1-1.471-9 may use LIFO. Treas. Reg. § 1.471-10 is the regulation provision that discusses the completed contract method, and is not specifically included in the LIFO authorization.

The Service has historically taken the position that the completed contract method and the use of inventories are mutually exclusive. In Rev. Rul. 59-329, 1959-2 C.B. 138, the Service stated that a taxpayer who reports income on the completed contract method may not consider costs of material, labor, supplies, etc. as inventory. "Such costs merely represent deferred expenditures which are to be treated as part of the cost of the particular contract and are to be allowed as a deduction for the year during which the contract is completed and the contract price reported as gross income." *Id.* The Service has taken this position because of the contradictory nature of the theories underlying LIFO inventory, and the completed contract method. LIFO is a method of accounting for inventory that allows a current recovery, through the LIFO adjustment, and increased cost of goods sold, for the effects of inflation throughout the year. The completed contracts method, on the other hand, permits the taxpayer to defer for an extended period the realization of

income from a construction project. Hand in hand with the deferral of income under the method, however, is the deferral of all costs that can be directly associated with a particular project. Permitting a taxpayer to recover the effects of inflation on supplies used on a particular project before the project is completed is in contradiction to this principal.

Unfortunately, with the reversal by the Federal Circuit of Spang Industries, Inc. v. United States, 791 F.2d 906 (Fed. Cir. 1986), rev'g 6 Cls. Ct. 38 (1984), the Service has enjoyed a uniform lack of success in litigating this position.

The Tax Court has considered this question on several occasions. On each occasion it has rejected our arguments that the use of a LIFO reserve in effect accelerates the deduction of costs associated with contracts not yet completed. Instead the court has found that the regulations at Treas. Reg. § 1.451-3 are concerned with the timing of deductions, while the regulations permitting the use of the LIFO method are concerned with the amount of deductions. Although the court agreed that the completed contract method regulations are to take precedence over the inventory provisions where they are in conflict, it finds no conflict between these two provisions. "[T]he long-term contract regulations do not require in all events any particular method of determining the amount of the raw materials component of cost of goods sold. We do not find, and respondent has not pointed us to, any conflict between the two sets of regulations as to the timing matter here in dispute." Peninsula Steel Products & Equipment Company, Inc. v. Commissioner, 78 T.C. 1029, 1051 (1982).

The same issue was put before the court in RECO Industries, Inc. v. Commissioner, 83 T.C. 912 (1984). The court declined to alter its position from Peninsula Steel, stating "respondent has not directed our attention in this case to (and indeed we fail to find) anything in the regulations prescribing the method for accumulating contract costs in an orderly fashion until the time arrives for recognition of income and expense." RECO Industries, 83 T.C. at 922. The court went on to state:

the pertinent regulation does not demand the specific identification and segregation of costs to a particular contract, we cannot accept the premise that the cost-deferral requirement means that the values of costs allocated to a contract must necessarily be the actual or historical costs or even costs computed on a FIFO basis.

RECO Industries, 83 T.C. at 924.

The Tax Court has considered this issue a third time, with predictable results, in Shasta Industries, Inc. v. Commissioner, T.C. Memo 1986-377.

The Service published its intention to continue litigating the position advanced in Peninsula Steel, in spite of the result reached in that case. I.R. News Rel. IR-83-90, June 29, 1983. The issue was then litigated in the Claims Court in Spang Industries, supra. The Claims Court found Service position to be correct, that the inclusion of the effects of inflation in current year costs is contrary to the match of income and expenses contemplated by the completed contract method. It was with this opinion in mind that the issue was set up in the [REDACTED] examination. Since that time, however, the Federal Circuit has overruled the Claims Court in Spang, and the technical divisions of the Service have modified their position to allow, subject to certain conditions, the combined use of inventories and the completed contract method.

The Federal Circuit, in reversing, cited to the Tax Court analysis in Peninsula Steel and RECO Industries with approval. It also discussed the amendments to the regulations under section 451. A proposed amendment to the regulations would have specifically disallowed the combined use of LIFO and the long-term contract method. This language was not included in the final regulations, which permit the use of inventories, subject to certain conditions, for tax years ending after December 31, 1982. The Federal Circuit found this to be further proof that the regulations before amendment contained no specific prohibition against the combination of LIFO and the completed contract method.

In addition to the reversal by the Federal Circuit, [REDACTED]

(Feb. 7, 1984) now takes the position that the use of inventories with the completed contract method will be acceptable, provided that materials that can be specifically identified with a contract are so identified, and that undedicated raw materials maintained in inventory are assigned to contracts at LIFO cost. We understand that the precedents mentioned above dealt with the issue of work-in-progress, rather than a transfer from inventory at the time of assignment, and that [REDACTED] is transferring goods from inventory at average cost rather than LIFO cost. The limitation of inventories to unassigned goods, rather than to work in progress is a distinction, but, we think, not one that operates in our favor. The incorrect valuation is certainly contrary to Service position, and should be challenged. Given our complete lack of success in litigating this area, and the


modifications to the regulations for years after [REDACTED], however, we do not see any chance of success in litigating [REDACTED], nor are we disposed to take an appeal if we are unsuccessful.

We understand that the taxpayer has displayed some willingness to concede other issues in exchange for a concession by the government of the LIFO adjustment. We cannot recommend litigation on this issue. Therefore, if no settlement can otherwise be reached, we concur with Appeals that the issue should be conceded.

If you have any questions with regard to this matter, please contact Ms. Clare E. Butterfield, at (FTS)566-3442.

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